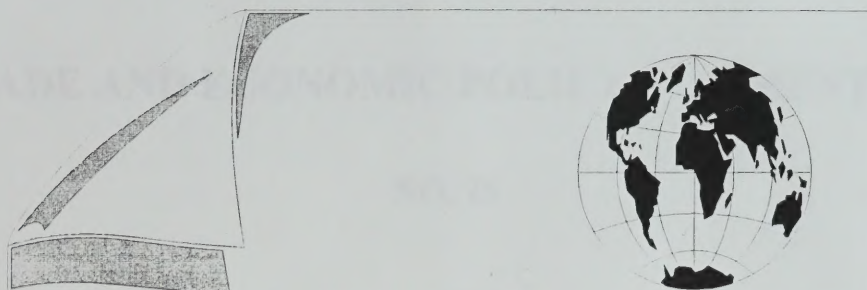


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TRADE AND ECONOMIC POLICY COMMENTARY No. 26



DEVELOPMENTS IN CANADA'S FOREIGN TRADE AND INVESTMENT IN 1998

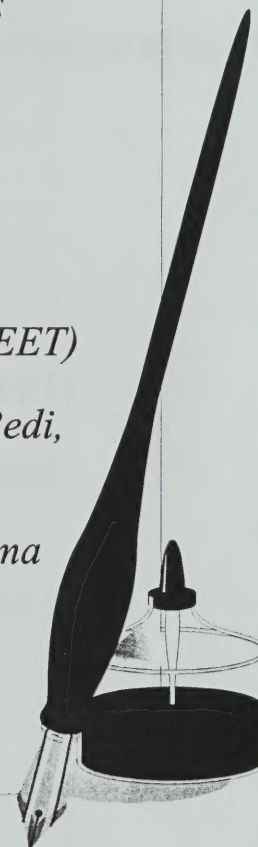
Prepared by

Trade and Economic Analysis Division (EET)

*Research Team: Ram Acharya, Anjali Bedi,
and Suzanne Desjardins*

Research Co-ordinator: Prakash Sharma

(May 1999)



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And International Trade*

TRADE AND ECONOMIC POLICY COMMENTARY

NO. 26

Developments in Canada's Foreign Trade and Investment in 1998

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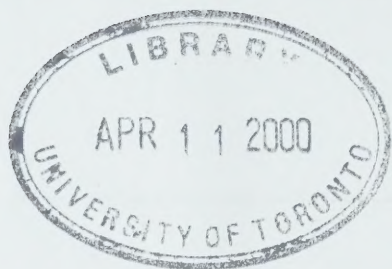
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FOREWORD

In a period of ongoing economic integration both regionally in North America and globally, trade and investment have a growing impact on the lives of all Canadians. As Canada's markets are increasingly to be found beyond our borders, and as Canadians increasingly depend on goods and services produced abroad, whether for consumption or as inputs to domestic production processes, the importance of external economic developments is heightened.

Accordingly, awareness of issues in the international economic domain has increased in Canada, both within the public policy community and amongst the general public. With this, there has been a concomitant expansion of demand for comprehensive information and analysis on Canada's trade and investment trends and performance. This commentary is intended to help fill this demand. It reviews and analyses the major developments in Canada's international trade and investment in 1998 in the context of overall economic trends and performance, both domestically and with respect to Canada's major trading partners.

In a year in which the global economy was buffeted by the then-spreading financial and economic crisis and that saw global growth slow sharply, Canada maintained a steady pace of economic expansion. Moreover, notwithstanding adverse developments affecting Canada's terms of trade, declines in exports to many major markets — to Asia in particular — and other spillover effects from the international financial turbulence, Canada was able to maintain solid growth in exports and to maintain sound external balances. The key to this performance was Canada's economic link to the United States, a link that was strengthened in 1998 by rapid growth in merchandise trade (with continued evolution towards higher-value-added goods) and vibrant two-way flows of direct investment. In short, Canada had a good year in trade in 1998, particularly in view of the difficult global economic conditions. This report covers all these developments; in so doing, it follows the standard structure of the Balance of Payments Accounts, reviewing performance on:

- the current account, which records Canada's international transactions in goods, services, investment income, and transfers; and
- the capital account, which records changes in cross-border financial claims and liabilities, including direct investment and portfolio investment flows to and from Canada.

The report was prepared within the Economic and Trade Analysis Division (EET) of the Department of Foreign Affairs and International Trade and overseen by John M. Curtis, Senior Economic Advisor and Coordinator. The research team consisted of Ram Acharya, Anjali Bedi and Suzanne Desjardins, with contributions from Charles-Antoine Allain and Samuel Lee. Prakash Sharma coordinated and provided considerable input through out the project. Dan Ciuriak edited the text in preparation for dissemination.

HIGHLIGHTS OF CANADA'S YEAR IN TRADE

For Canada, 1998 marked the seventh consecutive year of economic growth in what is emerging as one of the longest and most stable expansions of the post-war era. International trade and investment played an important role in sustaining Canada's economic growth through 1998, notwithstanding many adverse developments abroad, including widespread turbulence in international financial markets, the deepening of the economic and financial crisis in Asia and the spread of contagion to Russia and Latin America. An important contribution to Canada's economic performance in 1998 came from the robust growth of trade with the United States and a vibrant two-way flow of direct investment.

In 1998, Canada's overall economic highlights were as follows:

- Real GDP growth in Canada moderated to 3.1 percent from 4 percent in 1997, a solid performance in view of the slowdown in global growth to 2.5 percent in 1998 (1997: 4.2 percent). Canada ranked 3rd in the G-7 and 16th in the OECD in terms of growth.
- Consumer price inflation remained low at 0.9 percent, marginally below the lower end of the Bank of Canada's 1 to 3 percent target band. Meanwhile, the unemployment rate fell to 8.3 percent on the strength of a 2.8 percent growth in employment, which added 385,000 net new jobs to Canada's economy, the highest job growth in a decade. With this performance, the sum of the inflation and unemployment rates (sometimes referred to as the "misery index") fell to 9.2 percent, its lowest level since 1971.
- Buffeted by the turbulence in international markets, the Canadian dollar trended down from US\$0.699 at year-end 1997 to an historic low of US\$0.638 on August 27, 1998. With the progressive stabilization of international conditions, the dollar recovered to close 1998 at US\$0.648. For the year as a whole, it averaged US\$0.674, compared to US\$.722 in 1997, a depreciation of 6.6 percent. On a trade-weighted basis, and taking into account inflation differentials, the decline was 7.9 percent.¹

Canada's trade and investment contributed substantially to economic performance in 1998:

- Exports of goods and services grew 8.2 percent in real terms, almost on a par with the 8.5 percent pace in 1997 and more than double the rate of growth of real GDP.
- Imports of goods and services increased 5.8 percent in real terms compared to 14.6 percent in 1997. The easing of import growth from the torrid 1997 pace reflected both the moderation of growth in domestic demand and the lower exchange rate.
- Nonetheless, the current account deficit widened marginally to \$16.4 billion or 1.95 percent of GDP from \$14.3 billion or 1.75 percent of GDP in 1997. This was largely due to adverse developments on Canada's terms of trade (i.e., the price commanded by Canadian exports abroad fell relative to the price Canada paid for its imports). The terms of trade decline reflected in good measure the decline in energy and raw materials prices as the global economic slowdown weakened demand for these commodities.
- On the capital account, both foreign direct investment (FDI) into Canada and Canadian direct investment abroad (CDIA) reached record levels in 1998. For the sixth year in a row, CDIA exceeded FDI. The vibrant two-way flow of direct investment reflected in part a surge of cross-border mergers and acquisitions activity involving Canadian and U.S. firms, much of it in

¹ Calculated on the basis of the change in the real effective exchange rate index as reported by the IMF.
Source: International Monetary Fund, *International Financial Statistics*, various issues.

the telecommunications and high-technology sectors.

The direction of Canada's trade, as well as its structural composition, was significantly affected by global economic conditions in 1998:

- Exports to the U. S. grew strongly while sales to the European Union expanded more moderately; however, exports to other major markets declined, particularly to Asia, as that region suffered its worst recession of the post-war period. Merchandise exports to Latin America also declined as growth in key economies stalled.
- With these developments, the share of the U.S. in Canada's total merchandise exports rose to 83.6 percent (compared to 80.5 percent in 1997).
- Sectorally, machinery and equipment (M&E) exports displaced the auto sector as the top Canadian export sector (although this result reflected in part the impact on the auto sector of the major General Motors strike in midyear). M&E exports accounted for one-quarter of total Canadian goods exports. Meanwhile resources and resource-based products, while weaker than historically, accounted for 26 percent of Canada's exports. As regards services trade, the strongest growth was recorded in commercial services.
- Canada's import growth was broadly based. In regional terms, growth in imports from Asian economies was particularly strong, reflecting the improvement in their competitive position arising from exchange rate declines. Sectorally, import growth was paced by purchases of M&E, consumer and auto products, and commercial services.

Developments in 1998 set in sharp relief the significance to Canada of the economic link to the United States. Over the past decade, both Canada and the U.S. have become more integrated in the world economy, with real growth in exports of goods and services considerably outpacing overall growth in output. In Canada, the average real growth of exports of goods and services between 1988 and 1998 was 7.1 percent compared to average real GDP growth of 2 percent. In the U.S., the corresponding figures were 7.8 and 2.6. As a result, the share of exports of goods and services (in current dollars) in U.S. GDP rose to 11 percent in 1998 (from 8.5 percent in 1988), while it reached 41.1 percent for Canada up from 26.8 percent. In part, this trend was accounted for by increasing North American integration as the value of Canada-U.S. two-way trade, the single largest bilateral trade flow in the world, grew by 8.9 percent, compared to 8 percent growth in trade for the two economies with the rest of the world.

Both economies have thus benefited from the bilateral trading relationship, which has seen daily two-way trade grow from \$22 million a day in the 1950s to over \$1.5 billion in 1998.

| Average daily two-way trade in goods and services, Canada and the U.S. (\$ millions) | | | | | | |
|---|-----------|-----------|-----------|-----------|-----------|-------|
| | 1950-1959 | 1960-1969 | 1970-1979 | 1980-1989 | 1990-1998 | 1998 |
| Goods | 17 | 34 | 131 | 421 | 915 | 1,378 |
| Goods and services | 22 | 41 | 149 | 475 | 1,040 | 1,544 |

In terms of bilateral trade, Canada has been especially successful in expanding its surplus in merchandise trade and has also substantially reduced its deficit in services trade. Overall, Canada has turned a small but persistent deficit on the bilateral current account over the period 1988 through 1993 into a modest surplus in the years since.

MERCHANDISE TRADE

In 1998, the value of Canada's merchandise exports rose to \$322.3 billion, up 6.9 percent from \$301.4 billion in 1997. Meanwhile, Canada imported goods worth \$303.4 billion, up 9.3 percent from \$277.7 billion in 1997. This resulted in a merchandise trade surplus of \$18.9 billion or 2.25 percent of GDP, compared to \$23.7 billion or 2.9 percent of GDP in 1997.

Price developments played a particularly important role in Canada's overall merchandise trade performance in 1998. The volume of Canada's merchandise exports grew 8.3 percent, which was actually faster than the 7.3 percent growth in the volume of merchandise imports. However, the average price of Canada's merchandise exports declined in 1998, principally as a result of the slump in international commodity prices, while merchandise import prices grew comparatively steeply. Developments on Canada's terms of trade in 1998 are reviewed below.

Merchandise Exports

International demand conditions played an important role in Canada's overall merchandise export performance in 1998, particularly in influencing the direction, sectoral composition, and provincial breakdown of exports.

Exports to the United States grew 11.1 percent in 1998 as the U.S. economic expansion continued unabated. U.S. real GDP grew 3.9 percent, but U.S. domestic demand grew even faster at 5.1 percent. Underpinning U.S. domestic demand growth was buoyant consumer spending (supported in part by the record bull equity market) and continued strong investment activity, particularly in terms of the upgrading of technology. With exports to Canada's other major markets either expanding moderately or declining, the U.S. share of Canadian merchandise exports rose to 83.6 percent from 80.5 percent in 1997.

In Europe, the moderate growth of the European Union's larger economies as the continental economies prepared for monetary union appears to have been a factor in the modest pace of growth in Canadian exports to that region. Overall, the EU expanded by 2.8 percent in real terms in 1998, while the value of Canada's exports to the region grew by 4.5 percent.

Exports to Canada's other major markets were affected by the turbulent conditions that prevailed last year in much of the global economy. Merchandise exports to Asia fell particularly steeply as that region suffered its worst recession of the post-war period. The 22.5 percent slump in exports to Japan, Canada's second largest trading partner, was quantitatively the most significant, but exports to other Asian destinations were also down sharply, with few exceptions. Merchandise exports to Latin America also declined by 5.6 percent in 1998, as the financial turbulence spread to that region in August, following the onset of the crisis in Russia. The impact of the Asian and later more global crisis on Canadian exports is reviewed in more detail below.

Merchandise Imports

Canada's imports of goods rose 9.3 percent to \$303.4 billion in 1998, a considerable moderation from the 16.7 percent growth recorded in 1997. The slower import growth in 1998 reflected the slower pace of growth of Canadian domestic demand (3.4 percent in 1998 compared to 6.4 percent in 1997). The comparatively sharp 4.3 percent increase in the import price index, which in part reflected the pass-through of the depreciation of the Canadian dollar, was also a factor.

Growth in Canada's imports was broadly distributed across trading partners in 1998. International conditions influenced the source of Canada's imports in 1998. Imports from the U.S. increased by 10.5 percent, from Japan by 11.7 percent, from the EU by 6.1 percent, from East Asian economies by 14.5 percent, and from Latin America by 7.7 percent. As a result of these developments, the U.S. share of Canada's total imports increased to 77 percent from 76 percent in 1997, while East Asia's market share expanded to 12.3 percent from 11.9 percent in 1997.

Sectoral Developments in Merchandise Trade

The main developments in the sectoral composition of Canada's trade in 1998 reflected the commodity price decline (which resulted in energy sector trade falling in value terms notwithstanding volume gains), the General Motors strike in mid-1998, and the continued evolution of Canada's trade towards manufactured and higher-value-added products. Apart from the energy sector, the value of exports and imports expanded in all of the major sectoral categories. Notably, the automotive sector was displaced by machinery and equipment (M&E) as Canada's leading export sector in 1998.

Machinery and Equipment (M&E): A significant sectoral development in recent years has been the steady increase in the share of M&E in merchandise trade. In 1998, M&E exports grew 15.5 percent, reaching a level of \$78.8 billion, or about one-quarter of total goods exports. This performance culminated a five-year period in which M&E exports more than doubled; in fact, in this period, M&E exports increased a cumulative 114 percent from their level of \$36.9 billion in 1993. The strong performance of M&E exports has been in large part due to sustained demand from the U.S. M&E was also the fastest growing import sector, with growth of 10.9 percent in 1998, to reach a level of \$101.3 billion, a cumulative 91 percent increase since 1993.

Automotive products: Exports of automotive products rose a strong 12.2 percent to \$77.4 billion in 1998, while imports rose 9.8 percent to \$66.8 billion, despite the mid-year slowdown due to the General Motors strike. While the auto sector lost its status as Canada's leading export sector, it made the largest contribution to Canada's merchandise trade surplus in 1998, after forestry and energy, as exports exceeded imports by \$10.7 billion.

Agriculture and fishing, energy and forestry products: Exports in the combined category of agriculture, fishing, energy and forestry products fell 3.1 percent to \$84.2 billion while imports in these sectors fell 0.8 percent to \$28.4 billion. This reflected a decline in energy trade since exports and imports in both agriculture and forestry increased. The decline in energy trade was due to price declines as volumes expanded, by 4.9 percent in the case of exports and 2.7 percent in the case of imports. With these developments, the share of these sectors in total Canadian exports declined to 26 percent in 1998; this

compares to 30 percent as recently as 1993. The overall surplus in these sectors declined to \$55.8 billion in 1998 from \$58.2 billion in 1997.

Industrial goods and materials: Exports of industrial goods (which includes metals, chemicals, plastics and fertilizers, products which serve as intermediate inputs to production), increased 2.5 percent in 1998 while imports rose 10.5 percent. In the last five years, this sector has experienced high import growth, second only to M&E, reflecting in part the dynamism of final goods production in Canada in this period. Imports in these categories rose by a cumulative 87.5 percent between 1993 and 1998 while exports rose a cumulative 63.1 percent.

Consumer goods: Between 1993 and 1998, growth in consumer goods exports led all sectors, in good part due to strong U.S. demand. Meanwhile, buoyant consumer confidence in Canada translated into a strong demand for imported consumer goods. Canada typically runs a deficit in consumer goods trade; in 1998, the deficit widened further.

Table 1. Canada's goods trade in 1993 and 1998, (balance of payments basis)²

| Industry | | 1993 (Billions) | Share in total 1993 | 1998 (Billions) | Share in total 1998 | Growth 1993-98 |
|--------------------------|---------|-----------------|---------------------|-----------------|---------------------|----------------|
| Agricultural and fishing | Exports | \$16.15 | 8.5% | \$25.14 | 7.8% | 55.6% |
| | Imports | \$11.01 | 6.2% | \$17.26 | 5.7% | 56.8% |
| | Balance | \$5.14 | | \$7.88 | | |
| Energy | Exports | \$17.75 | 9.3% | \$23.90 | 7.4% | 34.6% |
| | Imports | \$6.97 | 3.9% | \$8.68 | 2.9% | 24.5% |
| | Balance | \$10.78 | | \$15.22 | | |
| Forestry | Exports | \$23.38 | 12.3% | \$35.17 | 10.9% | 50.4% |
| | Imports | \$1.57 | 0.9% | \$2.50 | 0.8% | 59.2% |
| | Balance | \$21.81 | | \$32.68 | | |
| Industrial | Exports | \$35.22 | 18.5% | \$57.45 | 17.8% | 63.1% |
| | Imports | \$32.16 | 18.2% | \$60.29 | 19.9% | 87.5% |
| | Balance | \$3.06 | | -\$2.83 | | |
| Machinery and equipment | Exports | \$36.85 | 19.4% | \$78.82 | 24.5% | 113.9% |
| | Imports | \$53.10 | 30.0% | \$101.30 | 33.4% | 90.8% |
| | Balance | -\$16.25 | | -\$22.48 | | |
| Automotive | Exports | \$48.61 | 25.6% | \$77.42 | 24.0% | 59.3% |
| | Imports | \$39.94 | 22.6% | \$66.76 | 22.0% | 67.2% |
| | Balance | \$8.67 | | \$10.65 | | |
| Consumer Goods | Exports | \$5.61 | 2.9% | \$12.42 | 3.9% | 121.4% |
| | Imports | \$21.37 | 12.1% | \$34.57 | 11.4% | 61.8% |
| | Balance | -\$15.76 | | -\$22.15 | | |
| Total trade | Exports | \$190.21 | | \$322.26 | | 69.4% |
| | Imports | \$177.12 | | \$303.40 | | 71.3% |
| | Balance | \$13.09 | | \$18.86 | | |

Source: Statistics Canada

² The sum of shares does not add up to a hundred because special transactions and inland freight and other balance of payments adjustments figures, which are part of the merchandise trade account, are not included in Table 2.

Merchandise Trade Balance

In the 1990s, strong goods export growth has helped expand Canada's traditional merchandise trade surplus as compared to the levels of the 1980s and previous decades. However, in 1998, with the value of goods imports growing by 9.3 percent compared to 6.9 percent for merchandise exports, the merchandise trade surplus fell somewhat to \$18.9 billion from \$23.7 billion in 1997. This compared to a recent peak surplus of almost \$42 billion in 1996.

Sectorally, the lower goods trade surplus in 1998 was accounted for by an expansion of the sectoral deficits in industrial goods and materials, and in consumer goods.

In terms of trading partners, Canada's merchandise trade surplus with the U.S. grew to \$35.9 billion in 1998 from \$31.1 billion in 1997. Elsewhere, the deficit in merchandise trade with the United Kingdom fell as Canadian exports to the U.K. increased whereas Canada's imports from the U.K. declined. However, Canada's merchandise trade surplus with Japan of \$3.6 billion in 1997 turned into a deficit of \$138 million in 1998, largely reflecting the contraction of imports in Japan as it experienced its deepest recession of the post-war period. With the rest of the world combined, Canada continued to run a goods trade deficit, which somewhat expanded in 1998.

Factors Impacting on Canada's Merchandise Trade

Developments on Canada's terms of trade in 1998³

In 1998, Canada's terms of trade fell rather sharply as import prices rose more steeply than did export prices.⁴ Given the large share of Canada's two-way trade that is denominated in U.S. dollars, a key factor behind the movement of the export and import price indexes in 1998 was the depreciation of the Canada-U.S. exchange rate.

As *Figures 1a* and *1b* show, Canada's export and import price indexes exhibit a high degree of correlation in their movements mutually and with the Canada-U.S. exchange rate. Thus, as Canada's exchange rate appreciated in the late 1980s, Canada's export and import prices fell. Subsequently as the Canadian dollar depreciated in the first years of the 1990s, export and import prices rose steeply. As the Canada-U.S. exchange rate stabilized at about Can\$ 1.37 from 1994 through mid-1997, so did export

³ Movements in the price of exports relative to the price of imports are referred to as changes in a country's "terms of trade". An improvement in the terms of trade (that is, a rise in a country's export prices relative to import prices) means that a country's international purchasing power has effectively increased: in other words, the earnings from a given quantity of exports purchase a greater quantity of imports. Conversely, a decline in the terms of trade requires a country to export more to pay for a given quantity of imports. For practical purposes, the terms of trade is normally measured as the index of average export prices divided by the index of average import prices. A wide range of factors can influence the terms of trade, including commodity price changes, exchange rate movements, domestic and international supply and demand conditions, changes in the mix of products exported and imported, and domestic cost and productivity trends; accordingly, care must be exercised in interpreting changes in this indicator.

⁴ Note: the direction of movement of average export prices in 1998 depends on the measure used. The implicit deflator for exports (derived by dividing the value of exports by the volume) fell marginally from 1.16 to 1.15, a decline of 1.2 percent. However, the fixed-weight index of export prices that Statistics Canada uses in calculating Canada's reported terms of trade rose marginally. The choice of index does not materially affect the conclusions although the numbers do change somewhat; in the analysis here, the fixed-weight index is used for calculation of the terms of trade.

and import prices. With the renewed depreciation since the onset of Asian Crisis, import prices and to a lesser extent export prices again moved higher.

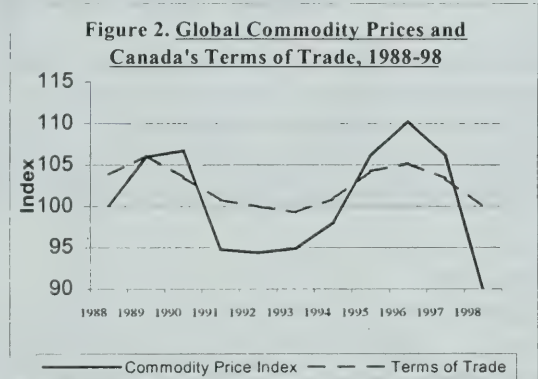
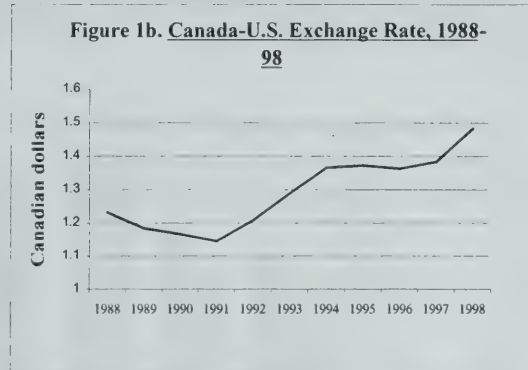
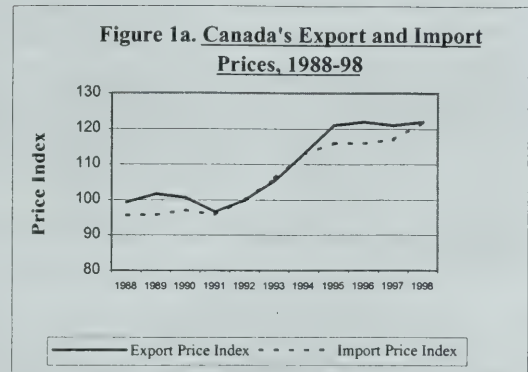
While the overall movement of prices for Canada's imports and exports thus is closely linked to movements in the exchange rate, the differential between the movements in the two indexes, which accounts for changes in the terms of trade, is predominantly influenced by movements in commodity prices. *Figure 2* compares movements in an index of global commodity prices to movements in Canada's terms of trade. As can be seen, the direction of movement in the terms of trade follows closely the movement of commodity prices. It is to be noted, however, that the fluctuations are smaller in the terms of trade than in commodity prices; this reflects the fact that Canada is a major exporter of manufactured goods as well as of commodities.

The commodity price index covers energy, food, industrial materials and other non-energy raw materials. Canada's exports in these categories amounted to \$142 billion compared to imports of \$89 billion in 1998. Net exports in these categories thus amounted to \$53 billion. (This surplus thus more than fully accounted for Canada's total merchandise trade surplus.)

Over the years, Canada has vastly expanded the share of manufactures in exports. At the same time, the share of commodity exports (i.e., energy, food, industrial materials and non-energy raw materials) has fallen to 42 percent in 1998 from 52 percent a decade earlier and 63 percent in 1978. Nonetheless, commodities continue to account for a large part of our exports both in an absolute sense and relative to the U. S. Moreover, the higher weighting of commodity stocks in Canada's equity market than in the U.S.⁵ underpins the continued perception (particularly in financial markets) of Canada as a commodity exporter. Thus, while commodity price fluctuations over time exert a lesser degree of influence over Canada's economy, they continue to be an important factor in the differentiation of Canada's economy from that of the United States.

Impact of the Asian Crisis on Canada's Exports in 1998

The Asian Crisis, which broke out with the devaluation of the Thai baht on July 2, 1997 and subsequently deepened and spread through the region and beyond, reached its peak in the early months

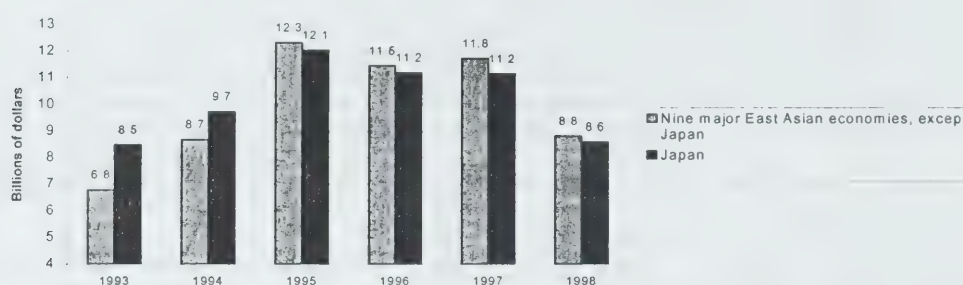


⁵ Commodity stocks currently represent 22 percent of the TSE capitalization, compared to 15 percent in the Dow Jones Average (prior to the most recent changes in the composition of the latter).

of 1998. With economic activity contracting sharply, exchange rates hitting their ultimate lows, and external financing not to be found, imports by the crisis-impacted countries plunged. Even countries in the regions that avoided crisis experienced slower growth (e.g., China), or slipped into recession (e.g., Japan). For trading partners both within and outside the region, the result was a sharp drop in export sales. In mid-1998, the financial turbulence spread to Russia and almost immediately thereafter to Latin America, in part due to the destabilizing effect of the decline in commodity prices that the Asian crisis had intensified.

For Canada, the Asian crisis resulted in a sharp drop in the value of exports from an average over the 1995-97 period of close to \$11.5 billion to Japan and close to \$12 billion to other major East Asian destinations to \$8.6 and \$8.8 billion respectively in 1998 (see Figure 3).

Figure 3. Canada's Exports to Key East Asian Economies



The share of Canadian exports to key East Asian economies thus fell substantially in 1998 as shown in the panel below.

Table 2. Share of Major East Asian Economies in Canada's Merchandise Exports

| | 1993 | 1994 | 1995 | 1996 | 1997 | 1998 |
|----------------------------|------|------|------|------|------|------|
| Peoples' Republic of China | 0.90 | 1.02 | 1.31 | 1.09 | 0.80 | 0.78 |
| Hong Kong | 0.41 | 0.52 | 0.67 | 0.46 | 0.59 | 0.43 |
| Indonesia | 0.25 | 0.21 | 0.25 | 0.35 | 0.27 | 0.17 |
| Japan | 4.53 | 4.30 | 4.56 | 4.06 | 3.73 | 2.70 |
| South Korea | 0.92 | 0.99 | 1.03 | 1.02 | 1.01 | 0.57 |
| Malaysia | 0.12 | 0.13 | 0.22 | 0.20 | 0.23 | 0.14 |
| Philippines | 0.10 | 0.09 | 0.12 | 0.11 | 0.14 | 0.08 |
| Singapore | 0.18 | 0.17 | 0.19 | 0.21 | 0.18 | 0.13 |
| Taiwan | 0.54 | 0.54 | 0.66 | 0.51 | 0.54 | 0.37 |
| Thailand | 0.20 | 0.18 | 0.22 | 0.21 | 0.16 | 0.09 |
| Total | 8.15 | 8.14 | 9.23 | 8.22 | 7.66 | 5.48 |

Source: CANSIM, Statistics Canada

Changes in the direction of Canada's export trade: a 10-year perspective

In view of the global economic conditions, the changes in the direction of Canada's export trade were particularly large in 1998. However, these changes in a sense only culminated a decade of structural change in Canadian trade. A number of factors have contributed to the observed trends.

Since the late 1980s, a wave of liberalizing agreements has transformed the international marketplace, with major implications for the structure and direction of global trade. By far the most significant for Canada in a direct sense was the Canada-U.S. FTA, signed in 1988. Not only did it cover three-quarters of Canada's overall trade, it marked a significant change in Canada's business culture and orientation. While far from eliminating the border as a factor in commerce, it did reduce the "border effect" for merchandise trade in half.⁶ Other agreements put in place in the last decade or so also had profound implications for Canada's trade;

- In the 1990s, economic integration in Europe deepened with the Single Market exercise (1992), transformation of the European Economic Community into the European Union (February 1992), the expansion of the EU to fifteen members (January 1995), and the first steps (by the EU-11) at the beginning of 1999 leading to a common European currency.
- New life was breathed into Latin American economic integration through Mercosur and the start of talks towards a hemisphere-wide free trade agreement (FTAA).
- The NAFTA brought Mexico into a free trade arrangement with Canada and the U.S.
- The Uruguay Round (UR) was concluded with the agreement at Marrakech in April 1994, resulting in the creation of the World Trade Organization, expansion of the rules-based trading arrangements to a large number of developing countries, and a lowering of trade protection globally. The gradual implementation of the UR measures has helped to diminish the significance of the more rapid and deeper reduction of trade barriers in North America, within Europe, and more generally within the many existing regional trading agreements.

At the same time, the international economy was buffeted by a series of major events. The collapse of the Soviet Union ushered in a decade of economic decline in the Former Soviet Union (FSU), transformation in Central and Eastern Europe and a significant absorption of Europe's energies in dealing with the issues raised — literally on its doorstep. In Asia, Japan's economic growth slowed sharply under the weight of the fallout of its burst financial bubble and the soaring yen; China emerged as an increasingly prominent player in international trade and investment; and much of the rest of East Asia went through the boom of the Asian Miracle and the bust of the Asian Crisis. A series of financial crises roiled international markets: in Europe (1992), Mexico (1994) and most recently in Asia (1997), which subsequently spread to Russia and Latin America (1998). And, most importantly for Canada, as technological change increasingly dominated economic development, the world's technology leader, the United States, experienced a boom of historic proportions.

⁶ A recent study by John Helliwell suggests that the border effects between Canada and the U.S. (i.e., the difference in the value of trade between a Canadian city and equi-distant partner cities in Canada and the U.S., taking into account size and other economic factors) was reduced by half following the Canada-U.S. FTA. See John Helliwell, How Much Do National Borders Matter?, Brookings Institution Press, 1998.

Not surprisingly, as shown in the panel below, the direction of Canada's exports has been profoundly affected by these changes. The most striking feature, of course, was the rise in the share of the U.S. in Canada's total exports over the period, coupled with a decline in the shares of the EU, Japan and other major East Asian economies. The only major trading region which did not lose share in this period was Latin America, which gained share in the period to 1997. However, with the global crisis in 1998, the shares of all major trading partners — Latin America included — fell except that of the U.S., which grew sharply (as shown in Table 3).

Table 3. Canada's Exports to Selected Major Trading Partners

| | | 1988 | 1997 | 1998 |
|---|-----------------------------|--------|--------|--------|
| US | Level (in billions of C \$) | 100.85 | 245.09 | 269.93 |
| | Share in total (%) | 72.8 | 81.9 | 84.7 |
| EU | Level (in billions of C \$) | 11.87 | 15.42 | 16.21 |
| | Share in total (%) | 8.6 | 5.2 | 5.1 |
| Japan | Level (in billions of C \$) | 8.81 | 11.17 | 8.61 |
| | Share in total (%) | 6.4 | 3.7 | 2.7 |
| Other Major East Asian Economies ⁷ | Level (in billions of C \$) | 7.19 | 11.76 | 8.84 |
| | Share in total (%) | 5.2 | 3.9 | 2.8 |
| Major Latin American Countries ⁸ | Level (in billions of C \$) | 1.87 | 5.25 | 4.69 |
| | Share in total (%) | 1.3 | 1.8 | 1.5 |

Source: CANSIM, Statistics Canada.

⁷ Other major East Asian economies includes People's Republic of China; Hong Kong, China; Indonesia, South Korea, Malaysia, Philippines, Singapore, Taiwan and Thailand.

⁸ Major Latin American countries include: Argentina, Brazil, Chile, Colombia, Venezuela and Mexico.

TRADE IN SERVICES

In 1998, exports of services reached \$45.9 billion, an increase of 8.8 percent over the \$42.2 billion in 1997. At the same time, imports amounted to \$52.9 billion, up a modest 3.1 percent from \$51.3 billion in 1997.

Services trade is classified into four categories: travel services, transportation services, government services, and commercial services (which includes accounting, legal, insurance, architecture, engineering, and management consulting).

- In 1998, commercial services exports grew by 7.4 percent to reach \$22.2 billion or 46.4 percent of total services.
- Travel exports grew 14 percent to reach \$13.9 billion; this represented 30.4 percent of total services exports. The comparatively rapid growth of travel services reflected the increase of inbound tourism to Canada.
- Transportation services expanded by 5.2 percent to reach \$8.8 billion or 19.2 percent of total services exports.
- Government services grew by 2.4 percent to \$0.95 billion; they accounted for 2 percent of total services exports.

As regards services imports:

- In 1998, commercial services imports grew by 5.2 percent to reach \$24.4 billion or 46.3 percent of total services imports.
- Travel imports grew 0.5 percent to reach \$15.6 billion; this represented 30.2 percent of total services imports. The slowdown in growth in travel services imports was the main factor behind the lower growth in services imports in 1998; an important underlying factor was the lower Canadian dollar.
- Transportation services imports expanded by 2.6 percent to reach \$11.8 billion or 22.4 percent of total services imports.
- Government services imports grew by 0.2 percent to \$0.63 billion; they accounted for 1.2 percent of total services imports.

Canada has traditionally been a net importer of services, overall and in all the individual services categories except government services. The largest deficit has traditionally been in the transportation sector, followed by commercial services and travel services. However, in recent years, the overall deficit has been progressively reduced. In 1998, the deficit in overall services trade declined to \$7 billion or 0.9 percent of GDP from \$9 billion or 1 percent of GDP in 1997, and from an historical peak of \$13.6 billion (1.9 percent of GDP) in 1993. The reduction over the past five years was due in large part to a reduction of \$1.6 billion in net travel payments over this period.

As regards the direction of Canada's trade in services, the United States remains Canada's main trading partner. However, the share of the U.S. in Canada's total services trade is smaller than is the case with respect to merchandise trade (Figures 4 to 7). Here as well, however, the U.S. is becoming an increasingly important market, accounting for 60.2 percent of Canada's services exports in 1998 compared to 56.6 percent in 1993.

Concerning the sources of services imports, the U.S. saw its share decline from 63.1 to 61.7 in 1998. The importance of Japan also declined slightly, while the EU gained market share.

Figure 4. Canada's Service Exports to Selected Economies, 1993

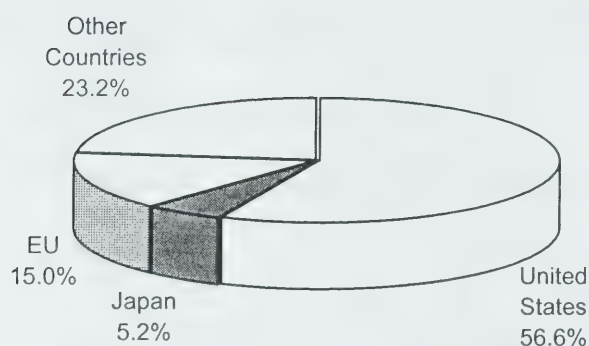


Figure 5. Canada's Service Exports to Selected Economies, 1998

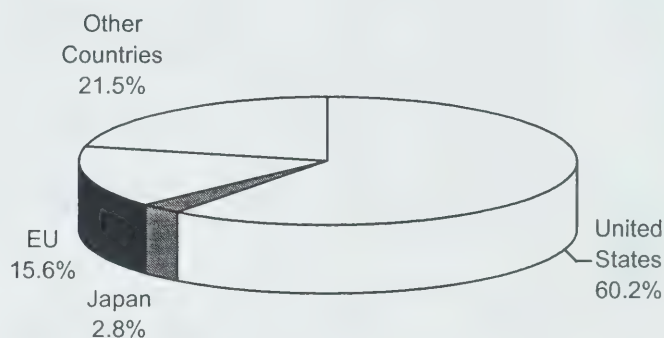


Figure 6. Service Imports from Selected Economies, 1993

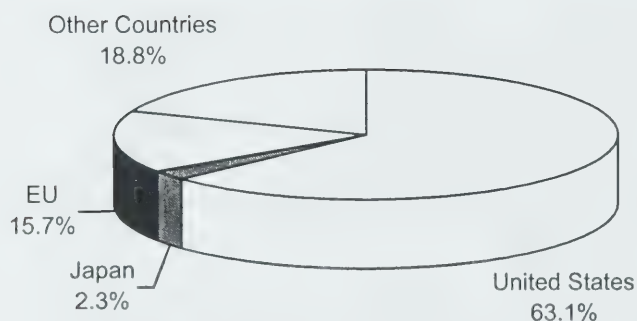
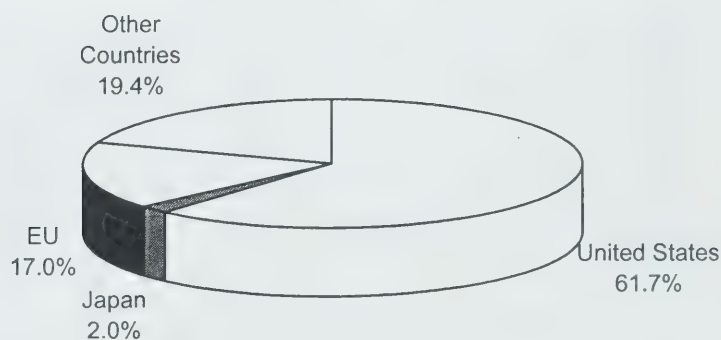


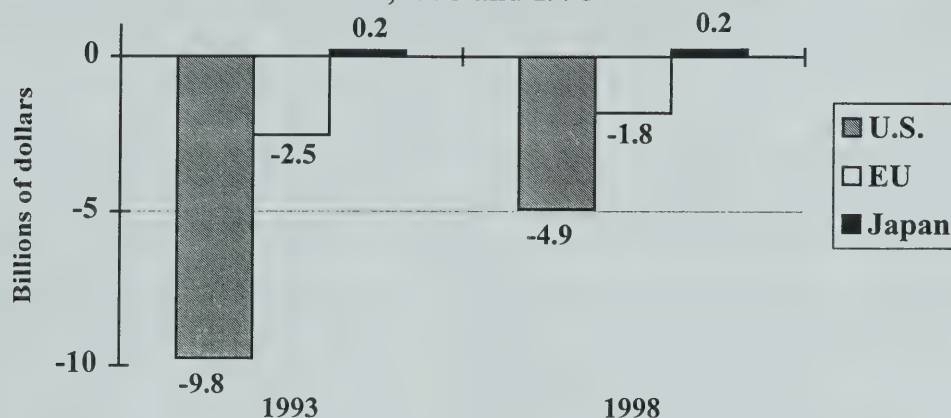
Figure 7. Service Imports from Selected Economies, 1998



Source: Statistics Canada

With these developments, Canada was able to reduce its deficit in services trade with both the U.S. and Japan while maintaining its surplus with EU, as shown in Figure 8.

Figure 8. Canada's Services Trade Balance with Selected Economies, 1993 and 1998



Source: Statistics Canada

Developments in Canada's Services Trade

The increasing importance of global trade in services is shown by the rise in its share of total global trade in goods and services to 19.2 percent in 1998 from 18.6 percent in 1990 and 15.65 percent a decade earlier. This increase is a function of many factors, including among others:

- the general expansion of services as a share of GDP in modern economies;
- cheaper and easier travel and communications; and
- the expansion of merchandise trade (for example, movement of goods across borders generates trade in transportation services while trade in specialized equipment generates trade in technical maintenance and other services).

In keeping with world-wide trends, Canada's exports and imports of services have risen at a steady pace over the last two decades. As a share of GDP, Canada's services exports have risen -- growing to 5.1 percent in 1998 compared to 3.9 percent in 1993. Services imports, which have been growing more slowly, have also expanded their share in GDP; in this case, however, the expansion has been minimal — from 5.8 percent in 1993 to 5.9 percent in 1998.

However, compared to merchandise trade, the pace of growth of services trade has lagged. Accordingly, the share of services in Canada's exports of goods and services has fallen from a peak of 13.6 percent in 1991, to 12.5 percent in 1998. The share of services imports has also fallen from a peak of 19.8 percent in 1991 to 14.8 percent in 1998.

Table 4: The share of services in Canada's GDP and Total trade

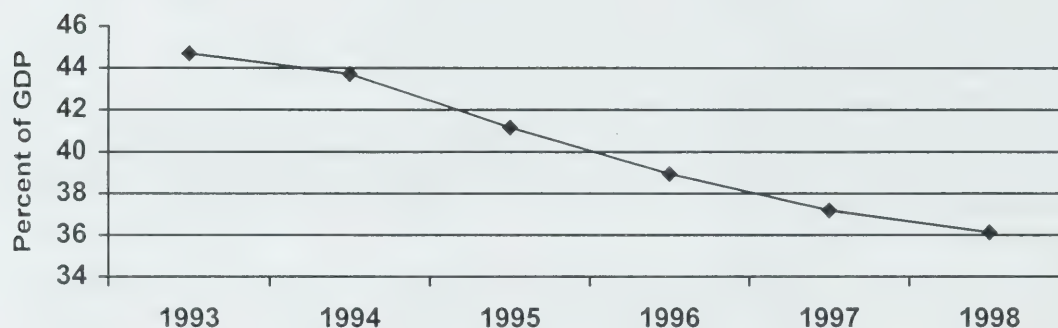
| | 1993 | 1997 | 1998 |
|--|-------|-------|-------|
| Share of services in total exports of goods and services | 12.9% | 12.3% | 12.5% |
| Share of services exports in GDP | 3.9% | 4.8% | 5.1% |
| Share of services in total imports of goods and services | 19.1% | 15.6% | 14.8% |
| Share of services imports in GDP | 5.8% | 5.9% | 5.9% |

The comparatively slow pace of growth of Canada's services trade is even more graphically shown in international comparisons. Measured in U.S. dollars, the cumulative growth rate of Canada's two-way trade in services from 1990 to 1998 was only 43 percent whereas the rate for the world was 64 percent and, for the U.S., 76 percent.¹

INVESTMENT INCOME

Canada has historically run a deficit on its net investment income account as money earned by non-residents on their Canadian investments have substantially exceeded the earnings of Canadians on their investments abroad. This reflects the fact that, for the most part, Canada has been a net capital importing country for much of its history; accordingly, the stock of Canada's external liabilities (on which foreigners earn investment income), which stood at \$970.8 billion at the end of 1998, was substantially greater than the stock of Canadian assets abroad (on which Canadians earn investment income), which was \$647.2 billion. As a result, Canada had a net international investment position of -\$323.6 billion or 36.2 percent of GDP. This share has been in decline in recent years as shown in Figure 9.

Figure 9. Net Foreign Liability as a Share of GDP, 1993-98



In 1998:

- The investment income earned by Canadians abroad was \$30.5 billion.
- The income earned by foreigners in Canada was \$59.6 billion. About half of this represented earnings from portfolio investment, a quarter the returns from foreign direct investment, and the remaining quarter the returns on other investment (which includes loans, deposits, reserves, and other assets).
- Canada thus had a deficit of \$29.1 billion on the investment income account.

¹The slow growth in services exports may be partly traced to the travel and transportation accounts. There is also some analysis that suggests that the differential extent of liberalization of goods versus services trade has been an important factor. As shown in the study by John Helliwell cited above (op.cit. p. 10), the border effects for merchandise trade have fallen in half for Canada-U.S. trade since the FTA, although hardly at all for services. This issue bears further research.

CURRENT ACCOUNT

The current account balance is the sum of the balances on merchandise trade, services trade, investment income and transfers. Analytically, a surplus on the current account indicates that a country has earned (or obtained via transfers) more abroad than it has paid out and is thus a net saver internationally (which is mirrored in a net outflow of capital and thus a deficit on the capital account). By the same token, a current account deficit means a country is dis-saving and thus is a net borrower internationally (as reflected in a net inflow of capital and thus a surplus on the capital account). In an accounting sense, a current account deficit reflects a shortage of domestic savings relative to domestic investment.

Since the early 1970s, Canada has consistently run deficits on the current account. In good measure, the emergence of a structural deficit in the current account coincided with the emergence of a structural deficit in public sector finances. In the 1990s, Canada has brought the public sector deficit down (the share of government budget deficit as a proportion of GDP reached its highest level of 8 percent in 1992, before turning into a surplus in 1997 and 1998). At the same time, however, the share of private savings in Canadian GDP has fallen continuously to 14.5 percent in 1998 from 23 percent in the first half of 1980s. As a result, Canada has consistently required net borrowing from abroad to finance domestic investment.

Table 5. Domestic Saving and Investment Position, 1981- 98

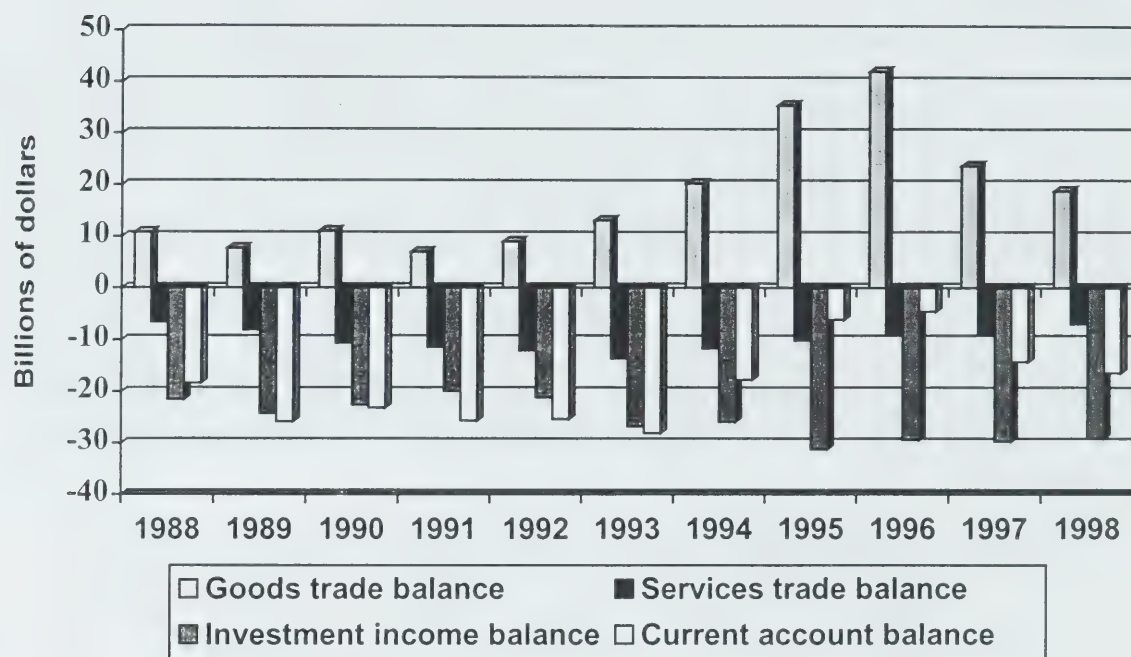
| Period | Private saving | Private investment | Excess private saving over private investment | Budget surplus (+) budget deficit (-) | Current account balance |
|---------------------|----------------|--------------------|---|--|-------------------------|
| Average (1981-1985) | 22.2 | 17.8 | 4.4 | -5.6 | -1.3 |
| Average (1986-1990) | 19.8 | 18.9 | 0.9 | -4.2 | -3.3 |
| Average (1991-1995) | 18.6 | 15.1 | 3.4 | -6.6 | -2.9 |
| 1996 | 17.6 | 15.2 | 2.4 | -2.2 | 0.6 |
| 1997 | 15.4 | 17.5 | -2.2 | 0.9 | -1.8 |
| 1998 | 14.4 | 17.5 | -3.0 | 1.3 | -2.0 |

Source: CANSIM, Statistics Canada

Note: Due to the statistical discrepancy in the national accounts, the sum of excess private saving over private investment and budget surplus or deficit does not add to current account deficit.

In 1998, as in each year of the 1990s except 1996, Canada had a deficit on the current account. The 1998 deficit of \$16.4 billion or 1.95 percent of GDP was up \$2.1 billion from \$14.3 billion or 1.75 percent of GDP in 1997 (Figure 10). The expansion in the current account deficit in 1998 was largely driven by a decline in the goods surplus and by higher interest payments on foreign-currency-denominated corporate debt.

Figure 10. Structure of Canada's current account, 1988-98



In 1998, Canada had a current account surplus with the U.S, but a deficit with the EU and Japan (Figure 11).

Figure 11. Current Account Balance with Major Trading Partners, 1988 - 98

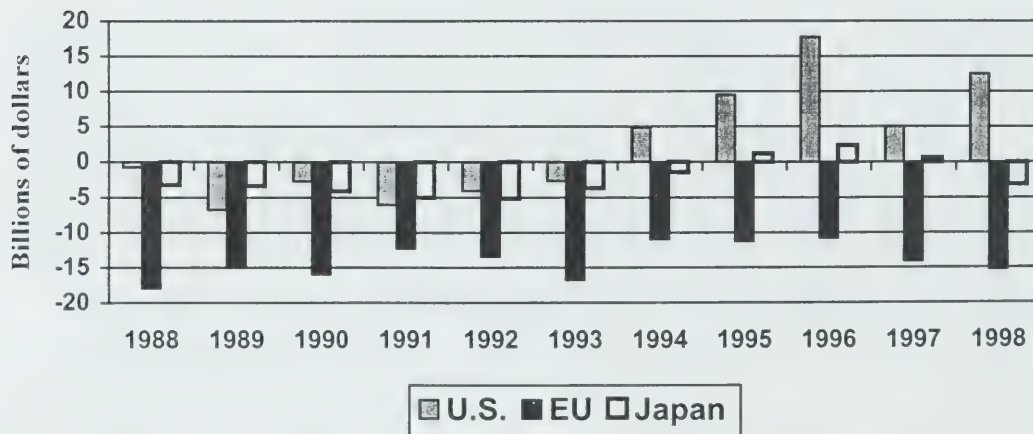
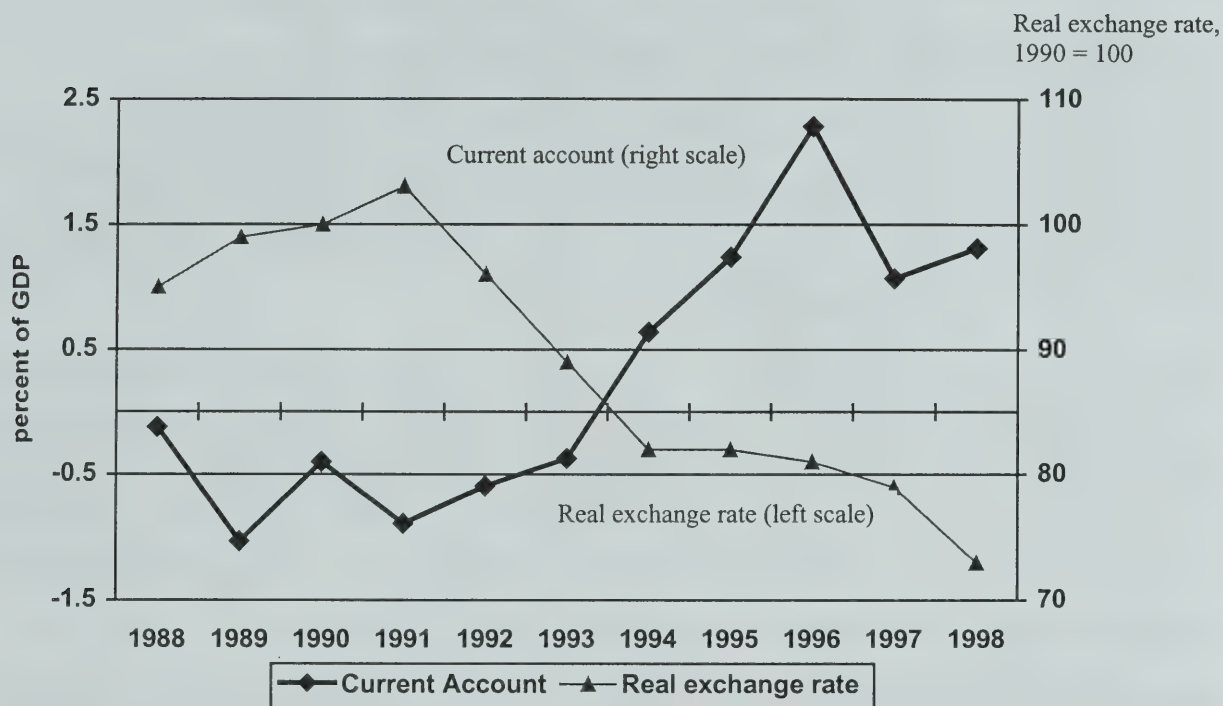


Figure 12. Canada's Real Exchange Rate vis-a-vis U.S. Dollar and Current Account Balance with the U.S.



Source: CANSIM, Statistics Canada

As can be seen from Figure 12 above, the shift in Canada's bilateral balance with the U.S. from deficit to surplus in 1994 mirrored the depreciation of the Canadian dollar in real terms.²

² In Figure 12, we have calculated the Canada's real exchange rate vis-à-vis the U.S. as the price of U.S. goods in terms of the price of Canadian goods (as the term real implies). This calculation shows that a bundle of Canadian goods which could buy one bundle of U.S. goods in 1990, could buy only 73 percent as much in 1998.

CAPITAL ACCOUNT

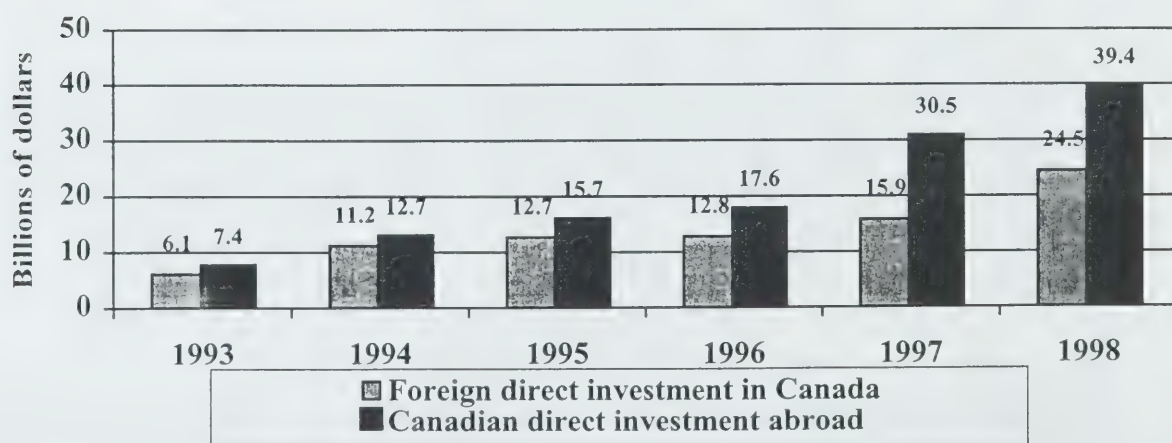
Direct Investment

Foreign direct investment (FDI) into Canada in 1998 rose 54 percent to a record \$24.5 billion. Energy, metallic minerals, finance and insurance were the leading sectors in attracting FDI. The U. S. was the largest source of FDI for Canada, contributing 85.7 percent of the total in 1998. The inflows from the U.S. increased to \$21 billion in 1998, up by 77.6 percent from \$11.8 billion in 1997. This record U.S. investment inflow resulted mainly from acquisitions of Canadian firms by U.S. investors, partly induced by the comparatively low value of the Canadian dollar in terms of U.S. funds. FDI inflows from the U.K., the other EU economies and Japan were lower than in 1997. Thus, the entire increase in FDI flows in 1998 was accounted for by U.S. investment.

The outflow of Canadian direct investment abroad (CDIA) in 1998 amounted to \$39.4 billion, up 29 percent from \$30.5 billion in 1997. The record investment outflow resulted mainly from Canadians acquiring production assets in the United States. In 1998, Canadian investments were concentrated in human-capital-intensive sectors such as finance and insurance, which had the highest share at 25.1 percent in the total outflows, as well as in traditional sectors for CDIA such as energy and metallic minerals. The U.S. remained the main destination of Canadian direct investment abroad, accounting for 77.3 percent of total outflows. In 1998, CDIA to the U.S. increased to \$30.5 billion, up sharply from \$11.5 billion in 1997. In contrast, Canadian investors reduced direct investments in the U.K. and Japan.

In recent years, CDIA has exceeded FDI; this trend continued in 1998 (Figure 13). For Canadian firms, direct investment abroad is motivated by a range of factors, including the desire to penetrate new markets and to increase their competitiveness through the acquisition of new technologies, resources and skills, including through mergers, acquisitions, partnerships, joint ventures and strategic alliances with other firms. Such investment abroad brings concrete benefits to Canada in terms of export opportunities and access to competitive inputs and R&D, leading to job creation in Canada.

Figure 13. Flows of FDI and CDIA, 1993-98



Source: Statistics Canada

With these developments, the stock of FDI rose to \$217.1 billion at year-end 1998 while CDIA reached \$239.8 billion. As can be seen in Table 6, finance and insurance had the highest sectoral shares in both CDIA and FDI stocks.

Table 6. Stocks of CDIA and FDI by Sector, Year End 1998

| Industry Group | CDIA stock in 1998 | | FDI stock in 1998 | |
|--|---------------------|------------------|---------------------|------------------|
| | Billions of dollars | Percent of total | Billions of dollars | Percent of total |
| Wood and paper | 6.5 | 2.7 | 16.5 | 7.6 |
| Energy and metallic minerals | 54.1 | 22.6 | 39.8 | 18.4 |
| Machinery and transportation equipment | 8.2 | 3.4 | 30.9 | 14.3 |
| Finance and insurance | 79.8 | 33.3 | 41.6 | 19.2 |
| Services and retailing | 26.4 | 11.0 | 20.9 | 9.6 |
| Other industries | 64.7 | 27.0 | 67.3 | 31.0 |
| Total | 239.8 | 100.0 | 217.1 | 100.0 |

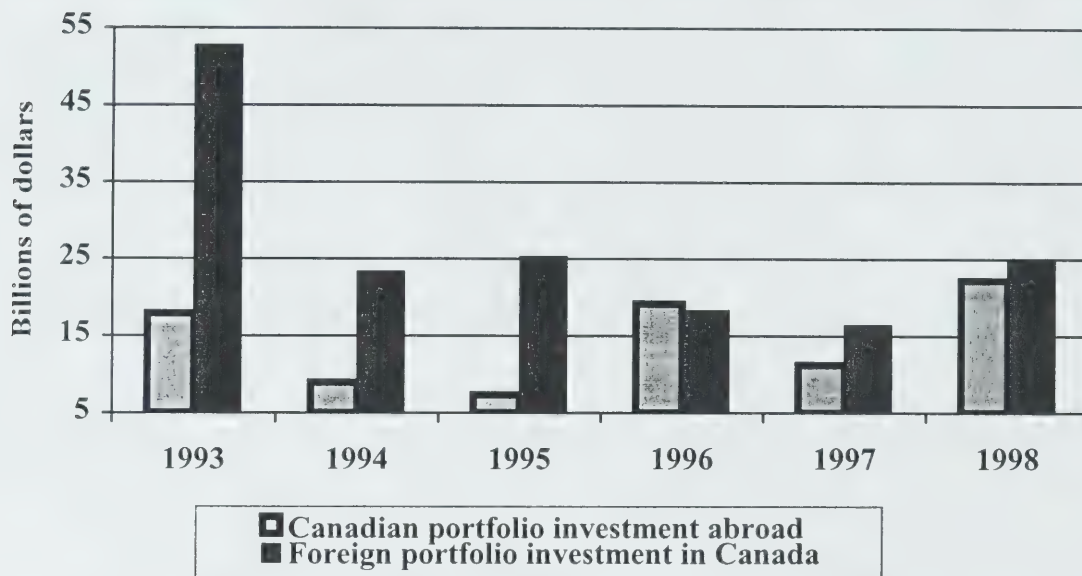
Source: Statistics Canada

As regards country of source, the U.S. accounted for 68 percent of the total FDI stock in Canada in 1998, followed by the U.K. at about 8 percent. With respect to the stock of CDIA, the U.S. accounted for 52.6 percent while the EU accounted for 19.3 percent.

Portfolio Investment

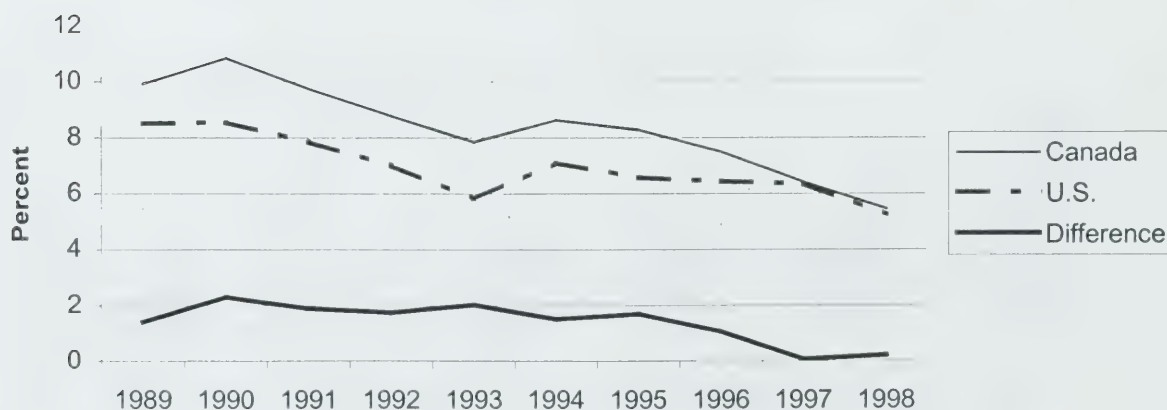
Portfolio investment flows, which include investments in bonds, stocks and money market instruments, were up sharply in 1998, with inflows continuing to exceed outflows in line with historical trends. Portfolio inflows were \$25 billion, an increase of 52 percent over 1997. Portfolio outflows meanwhile nearly doubled, rising 98 percent to \$22.2 billion in 1998 (Figure 14).

Figure 14. Foreign Portfolio Investment in Canada and Canadian Portfolio Investment Abroad, 1993-98



Portfolio investment flows respond to a wide range of factors that affect the various types of instruments in which such investments are made, including exchange rate expectations, interest rate differentials and equity market performance in particular. One key factor for Canada in recent years was the elimination of the interest rate differential vis-à-vis the U.S., as shown in Figure 15.

Figure 15. Long-term Government Bond Yields, Canada and the U.S., 1989-98



With the developments in 1998, which continued to see inflows exceeding outflows, the stock of portfolio investment abroad by Canadians reached \$143.9 billion, whereas the stock of foreign portfolio investment in Canada rose to \$506.3 billion.

SUMMARY OF BALANCE OF PAYMENTS

Table 7 summarizes Canada's overall balance of payments picture in 1998. By standard accounting practices, a country's balance of payments account is always balanced. That is, a current account deficit has to be offset exactly by running a capital and financial account surplus and vice versa. In 1998, the former was the case.

Of particular note, the Canadian official settlement balance was a positive \$7.452 billion, which indicates that the Bank of Canada added that much to its foreign exchange reserve, a positive development in what was overall a highly successful year for Canada in terms of its international economic activity.

Table 7. Canada's 1998 balance of international payments accounts

| | | | |
|--|-----------|-----------|------------|
| Current Account | | | |
| • Exports of goods and services | \$368,164 | | |
| • Imports of goods and services | \$356,256 | | |
| a. Trade balance | | \$11,908 | |
| • Investment income abroad | \$30,498 | | |
| • Investment income of foreigners | -\$59,597 | | |
| b. Net investment income | | -\$29,100 | |
| c. Net current transfer | | \$807 | |
| 1. Current account balance (a + b + c) | | | -\$16,385 |
| Financial Account | | | |
| • Canadian direct investment abroad | -\$39,414 | | |
| • Foreign direct investment in Canada | \$24,470 | | |
| d. Net foreign direct investment | | -\$14,944 | |
| • Portfolio investment abroad | -\$22,233 | | |
| • Portfolio investment in Canada | \$25,006 | | |
| e. Net portfolio investment | | \$2,770 | |
| f. Other net investment | | \$21,632 | |
| 2. Financial account balance (d + e + f) | | | \$9,461 |
| Of which: | | | |
| - official international reserve | | | -\$7,452 |
| - non-reserve financial account | | | \$16,913 |
| 3. Capital account balance | | | \$4,976 |
| 4. Statistical discrepancy | | | \$1,948 |
| Balance of payments (1 + 2 + 3 + 4) | | | \$0 |

Source: Statistics Canada

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